

S 7-23-03

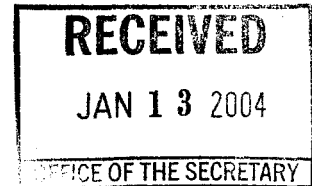


Security  
Traders  
Association

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January 9, 2004

Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0609



**Re: Securities Exchange Release No. 48709; File No. S7-23-03  
Proposed Rule Short Sales**

Dear Mr. Katz:

The Security Traders Association ("STA") is pleased to provide the U.S. Securities and Exchange Commission ("Commission" or "SEC") with comments on the Commission's proposed new Regulation SHO under the Securities Exchange Act of 1934 replacing Rules 3b-3, 10a-1 and 10a-2 and amending Rule 105 of Regulation M.<sup>1</sup> Specifically the proposed rule would create a uniform bid test allowing short sales to be effected at a price one cent above the consolidated best bid, require short sellers in all equity securities to locate securities to borrow before selling and impose strict delivery requirements on securities where many sellers have failed to deliver the securities. In essence, the proposed rule, drafted partially in response to the SEC's 1999 request for comment on short sale regulation<sup>2</sup> is designed to address naked short selling, regulatory arbitrage and the necessity for "bid test" type regulation.

The STA applauds the Commission's efforts in addressing the concerns resulting from regulatory arbitrage as raised by the STA in our White Paper<sup>3</sup> and in crafting uniform rules addressing short sales in general, however, the STA does have concerns that it believes, based on its expertise in the trading arena and its concern for the investing public, must be raised and considered by the Commission before proposed Regulation SHO is adopted. Respectfully, the STA believes that the SEC, having intently studied this area for approximately four years before issuing its proposal should provide the public and the industry with more than an approximate two month period to study and provide comment on such a significant, complicated and meaningful proposal.

<sup>1</sup> Securities Exchange Act Release No. 48709 (October 28, 2003); 68 FR 62972 (November 6, 2003).

<sup>2</sup> Securities Exchange Act Release No. 42037 (October 20, 1999); 64 FR 57996 (October 28, 1999).

<sup>3</sup> Security Traders Association, *Special Report; Fulfilling the Promise of the National Market System. STA's Perspective on U.S. Market Structure* (August 2003). (hereinafter "STA White Paper").

The STA is a worldwide professional trade organization that works to improve the ethics, business standards and working environment for its members, who are engaged in the purchase, sale and trading of securities. The STA represents the shared interests of its approximately 7,000 members that belong to one of 29 national and international affiliate organizations. The STA is the largest organization of its kind in the world

## **DISCUSSION**

Proposed Regulation SHO is a wide ranging and comprehensive revision of the regulatory regime applicable to short selling of equity securities. Within the limited time allotted to the public to comment on this proposal, the STA is providing comments on only certain aspects of the proposal that it believes must be addressed immediately.

### **Pilot Program and Determining the Necessity of A Uniform Bid Test Rule**

The STA strongly supports the proposed pilot program which would suspend the operation of the proposed uniform bid test of proposed Rule 201 for specified liquid securities. The STA believes, however, that a two year period is much too long and that more securities should be included in within the program. The STA believes a six month period would provide more than enough market operation information for the markets and the SEC to assess the effects of unrestricted short selling on market volatility, price efficiency and liquidity and reach a determination as to whether a uniform bid test is necessary for liquid securities and, more importantly, whether a uniform bid test, in the context of seriously enforced locate and delivery requirements, needs to be maintained for any class of security. Moreover, the industry and the Commission already possess information concerning the trading of NASDAQ securities unrestricted by a short sale rule since a number of markets and ECNs permitted such conduct over the last year.

The STA believes that the scope of the pilot program should be expanded to include less liquid securities. As currently proposed, the uniform bid test is not applicable to NASDAQ SmallCap and Over-the-Counter (“OTC”) securities. The Commission’s support for this exemption is that a short sale rule has never been applied to these securities in the past and that the proposed locate and delivery rules will prevent naked short selling situations.<sup>4</sup> If the Commission has already determined that a uniform bid test is not necessary to obtain the stated objectives of short sale regulation in markets that are less transparent, less liquid and proven to be the class of securities more likely to be subject to a “bear raid” or “short squeeze” manipulation, it is difficult to understand, and the Commission has not expressed its reasons why, a uniform bid test is

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<sup>4</sup> 68 FR at 62981.

necessary for liquid or illiquid NASDAQ NMS and Listed securities. Therefore, the STA respectfully requests that the proposed pilot program also include less liquid NASDAQ NMS and Listed securities to enable the Commission to make a determination as to whether or not a uniform bid test is a regulation necessary to ensure accomplishment of the objectives of short sale regulation.

In reaching this determination, the STA respectfully requests that the Commission bear in mind that, as the STA believes, a bid or tick test rule is one that is largely supported and promoted by issuers who are legitimately concerned about maintaining the price level of their stock. It is equally important, however, that public investors be allowed to identify “overvalued” securities and trade pursuant to that legal investment strategy. Short selling overvalued securities is a legal and acceptable trading strategy employed by investors that may not only result in a profit but may also result in an ultimate price in the security that is more reflective of the financial condition of the issuer and a more accurate representation of the natural forces of supply and demand. Moreover, seriously enforced locate and delivery rules combined with adequate and robust market surveillance should help prevent “bear raid” and “short squeeze” type manipulations and assist regulators in identifying such market activity should it exist. After all, there are no rules which specifically address trading in a rising market, but regulators employ surveillance and examination techniques that identify manipulative activity. These same techniques are applied in falling markets and the commission should determine if such regulatory activity and enforced locate and delivery rules are adequate to protect the marketplace from damaging short sale activity. Additionally, if the answer to this question is in the affirmative, the Commission should determine whether a rule designed solely to artificially shield the price of a security from the natural forces of supply and demand and legitimate investment activity is necessary or desirable in today’s marketplace.

### **Uniform Bid Test Rule**

Understanding that while the pilot program is in effect and the Commission determines the necessity of a short sale rule, there needs to be continuing short sale regulation, the STA fully supports the SEC’s efforts to establish a uniform pricing test applicable to all covered equity securities. In our White Paper, the STA stated that “regulatory arbitrage serves to reduce the overall quality of our markets and must be eliminated.” The STA also stated that it believed “that the SEC must mandate the adoption of consistent, standardized trading rules, such as the short sale rule, among markets trading like classes of securities (i.e. NASDAQ securities and exchange-listed securities).”<sup>5</sup> In this light, the STA fully supports the Commission’s efforts in this area to resolve and eliminate this aspect of regulatory arbitrage and believes that a uniform short sale rule applicable to all equity securities will allow marketplaces to compete with each

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<sup>5</sup> STA White Paper at p. 7.

other on the basis of execution quality, not regulatory disparities, and increase public investor confidence in the markets.

Specifically, proposed Rule 201 of Regulation SHO provides that all short sales in listed and Nasdaq National Market securities, wherever traded, be effected at least one cent above the consolidated best bid at the time of execution. Although the STA supports the uniformity of the rule's application, it has concerns about the rule's operation and effect.

### **Operation**

The STA believes that establishing a new requirement that all short sales be effected one cent above the consolidated bid establishes an unnecessary, expensive and arduous programming and implementation burden on the industry at a time when firms are already under tremendous regulatory obligations. Firms have been operating under the NASDAQ bid test for approximately ten years and already have their systems programmed to comply with the rule.<sup>6</sup> The primary difference between the current NASDAQ rule and the proposed rule is that the NASDAQ rule allows short selling when the best bid is better than the previous bid (upbid) and prevents it when the best bid is worse than the previous bid ("down bid"). The industry, public and the Commission have approximately ten years experience with the operation of this rule and the SEC has not explained why the operation of this rule has, in any way, been ineffective or failed to address the type of conduct short sell regulation is designed to address. Moreover, requiring firms to completely reprogram or implement new systems when existing systems and rules have proven to be effective in this regard is an unnecessary cost to be placed on the industry. The STA recommends that the SEC adopt the existing structure of the NASDAQ short sale rule with the exception of substituting the consolidated best bid for the NASDAQ inside bid. It is our belief that this will create a uniform short sale rule that will address the concerns raised by the Commission and allow the industry to implement the proposed rule in little time at acceptable expense.

### **Market Maker Exemption**

The STA believes that the elimination of the market maker exemption<sup>7</sup> is a grave error and could result in significant harm to public investors by reducing liquidity, speed of execution and the ability of market makers to test liquidity and engage in price discovery for the purposes of providing better execution to customer orders. The Commission believes its previous stated reasons for providing the market making exemption in that allows market makers to enhance

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<sup>6</sup> NASD Rule 3350.

<sup>7</sup> Current market maker exemption from short sale rule for Nasdaq and the NASD Alternative Display Systems can be found at NASD Rule 3350c(1).

liquidity by adjusting inventory positions quickly and provide market stabilizing liquidity are no longer persuasive because market makers should rarely need to sell stock at or below the bid and because of its concern that market makers may engage in speculative and non bona-fide market making activity.

Market makers may commit significant capital to meet customer demand to purchase securities in a fast rising market resulting in significant short positions at a potential loss. Without allowing market makers to engage in further short selling activity, it could subject the market maker to significant and unmanageable losses and make it unwilling to commit significant capital in future situations. Such a result will have the effect of reducing liquidity, widening spreads and cause customer executions at inferior prices in a less timely manner. Allowing the market maker to sell short into the bid will permit the market maker to manage this risk and continue to foster better executions for customers by maintaining a market maker's willingness to risk capital.

At a minimum, the STA argues that the market maker exemption should be maintained for bona fide market making activity that is engaged in solely for the purpose of ensuring better and best executions of customer purchase orders. For instance, in a situation where a specialist or market maker is holding and displaying a customer limit order to buy at the then consolidated bid and trading occurs at that price away from it, although the market maker or specialist may not have a manning or other obligation to fill the order, to ensure best execution of such order the market maker may determine to sell short in a principal capacity to fill it. The operation of Regulation SHO would prevent the execution of this trade because it could only be executed a penny above the limit order price or not be executed at all. The operation of the rule would also prohibit a market maker or specialist from filling completely a customer buy order when its limit order protection obligations only require a partial fill since the outstanding portion of the order would be executed as a principal short sale execution. Similarly, a specialist at one exchange would be prohibited from establishing a short sale position to fill a customer buy order based on a trade through rule violation by another marketplace and be subjected solely to the trade through complaint process which may or may not result in an execution.

Before the Commission completely removes an exception to the short sale rule that has been in effect for approximately ten years, the STA believes that the Commission should conduct a study, particularly relevant in the now decimalized market which demonstrates that its preliminary conclusions are true and that the operation of the exception does not result in enhanced liquidity and that market makers rarely sell at or below the consolidated bid.<sup>8</sup> This

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<sup>8</sup> Even if such a study were to demonstrate that such selling activity does occur rarely, even rarer instances of short sale manipulation activity (or the fear thereof) should not serve as support for eliminating the market making exemption and prohibiting market makers from providing better and best execution to customer orders as described above.

request is particularly justified when the SEC is, at least partially, relying on statistics from a six year old NASDAQ study conducted in a non-decimalized market.<sup>9</sup>

The Commission's concern about non-bona fide market making activity serving a support for the removal of this long-standing exemption is misplaced. The NASD and other regulators consistently review the marketplace for speculative short selling activity under the guise of exempted market maker short sell transactions as part of its regulatory processes and such speculative trading activity is not difficult to detect. As the Commission is aware, any exception to a rule could be abused. The question as to whether or not that is a reason to not provide such exception is determined by whether regulatory authorities and the industry can establish, maintain and enforce procedures to detect and deter such abuse. The NASD has had such a regulatory program in place for years and the Commission has not presented any evidence that this program has been ineffective.

The STA believes that the elimination of the market making exemption from the short sale rule could have deleterious effects on the marketplace and the public investor and should not be eliminated before further study of today's marketplace justifies this significant change and it is further demonstrated that current regulatory programs to limit the exemption to bona fide market making are ineffective. The instant elimination of this exception before further study may also have a negative impact on a market makers willingness to commit capital and hinder the execution of larger transactions.

### **VWAP Transactions**

We support the SEC's proposed codification of previously issued no-action letters exempting the ultimate customer execution of certain value weighted average price ("VWAP") transactions from the short sale rule. The STA, however, does not believe that the exception goes far enough because the operation of the proposed rule and its effectiveness during after hours trading would prohibit a significant amount of institutional trading activity which occurs in the NASDAQ marketplace today on a daily basis.

Institutions and sometimes retail customers frequently enter large short sale orders for NASDAQ securities that are to be executed net (thus, not qualifying for the riskless principal exception from the bid test), in a principal capacity, on a VWAP basis. Pursuant to the current operation of the NASDAQ short sale rule, all transactions with the street to fill the order are executed in compliance with the short sale rule. When the order is completed and ready to be executed to the customer, it is not unlikely that the short sale rule would preclude its execution forcing the market maker to hold the transaction for execution at the next upbid or execution after the market close when the NASDAQ short sale rule is no longer in effect. Since proposed Regulation SHO

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<sup>9</sup> D. Timothy McCormick and Bram Ziegler, *The Nasdaq Short Sale Rule; Analysis of Market Quality Effects and The Market Maker Exemption*, NASD Economic Research, (August 7, 1997).

would eliminate the upbid requirement and the rule would be effective after hours, such transactions could not be executed unless it was done a penny above the consolidated bid. Forcing dealers to execute in this manner could result in a worse execution for the customer.

The STA believes that the exception for VWAP transactions should be extended to the transactions described above and that doing so would not increase the potential for manipulation or abuse since all the transactions effected with the street in these types of scenarios would be executed in compliance with the short sale rules. The STA believes that market transparency and best execution would be enhanced by allowing such transactions to be executed and reported immediately by excepting them from the uniform bid test rule. The STA believes that such transactions should be immediately reported along with a modifier that reflects the execution at a VWAP basis. In the NASDAQ market this is accomplished with a .W modifier. Excepting these .W reported trades from the short sale rule would allow them to be executed and reported immediately and provided the regulators with an audit trail to determine the propriety of the transaction.

### **After Hours Trading**

The STA believes that NASDAQ standard of applying the short sale rule during normal market hours should be maintained and extended to proposed Regulation SHO. The disseminated quotations and trade prices reflected in the after hours market are the result of a market with many less participants, less liquidity and much higher volatility than that of the regular hours session. Until the after hours markets significantly increase in volume and liquidity, enforcement of the short sale rule during that time period has the significant potential of creating even more aberrational quotation and pricing activity unreflective of the true market for the security. If the Commission determines to implement the uniform bid test during after hours, the STA supports the principle that the last disseminated consolidated best bid operate as the benchmark for rule compliance.

### **Unconditional Contracts to Purchase Securities**

The STA believes that the proposed additional requirement in Regulation SHO to satisfy the “unconditional contract” exception<sup>10</sup> to the definition of short sale that necessitates that the specific price and number of shares be determined at that time the order is entered in order for the broker-dealer to conclude that it had entered an unconditional contract to purchase securities and could now consider itself long the security is an unnecessary restriction that impedes legitimate market making activity that generally improves market stability. In some institutional transactions, a market maker and its institutional customer enter into an unconditional contract whereby the market maker agrees to purchase stock from a customer at at least a specific price but possibly better and the institutional customer understands that he has sold short the security

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<sup>10</sup> 17 CFR 240.3b-3(b).

at a price which will be determined later in the trading day and be no worse than the specific minimum, purchase price agreed to. This could also be in the form of a VWAP or Market on Close order. For example, the market for ABCD is \$10.00 bid, \$10.05 offer. An institutional customer contacts a market maker and communicates its desire to sell short 25,000 shares of ABCD. As a result of further negotiation, the market maker and customer agree that the market maker will purchase 25,000 ABCD at \$9.98 a share but will work the order throughout the day to attempt to get the customer a better price. We agree that at the time that the bilateral stop transaction is entered into and the parties thereto agree to its terms, the market maker is effecting a short sale on behalf of its customer. At that time the market maker would be subject to the trading restrictions of the short sale rule and could only enter into the bilateral stop transaction if the market for the security was on an up-bid or it was, otherwise, a legal short sale

As a result of the above negotiation and agreement, the market maker and customer have entered into a contract whereby the market maker purchased 25,000 shares of ABCD at \$9.98 or better. There is no question in the mind of the customer as to whether it has just sold 25,000 ABCD and no question in the mind of the market maker that it has just purchased 25,000 ABCD. The only question that remains is if the execution price will be \$9.98 a share or better.

Assuming the actual market maker purchase from the short selling customer is effected in compliance with the Short Sale Rule's requirements, the structure of the transaction and its investment and trading purposes impose a necessary trading strategy that removes any incentive on the part of the market maker to accelerate the decline of the price for such security. In this scenario, the market maker has stopped the customer's order at a specific price with the undertaking to attempt to get the customer price improvement. Because the market maker has provided an absolute, minimum purchase price for the stock, it does not make business sense for the market maker to aggressively sell into the market with the intent of accelerating the decline in the security's price. Such an aggressive trading strategy would increase the market maker's risk of suffering a loss on the transaction. Moreover, from a pure customer service standpoint, an aggressive selling strategy would inhibit the market maker from obtaining an improved price for its customer, decreasing the likelihood that such customer would bring future trading business to the market maker. As described above, it is in the market maker's and the customer's best interest to attempt to sell the stock into the market place with as little downward pressure on the market as possible, and, as such, the trading resulting from this transaction structure does not represent the type of potentially market destabilizing conduct the Short Sale Rule is designed to prevent.

### **Options Market Maker Hedge Exemption**

Regulation SHO should include an exemption for options market makers and specialists ("Options MMs") for sales that serve as bona fide hedges to their long-side options positions. Exempting Options MMs in this way will add to their ability to facilitate options order flow without compromising the goals of the newly proposed Short Sale Rule.



In the current era of options trading, volume guarantees for all account types (i.e., customer, institutional and broker-dealer) have enhanced the use of options as risk-reducing hedging tools. Professional order flow now has the ability to access options quotes near instantaneously and execute electronically in sizes that often exceed liquidity levels in the underlying stock. While the exchanges and the SEC have been successful in their efforts to expand the liquidity of the options markets, and unfettered access to that liquidity, the increase in professional order flow has heightened the need for the facilitating Options MMs to hedge in the underlying stock quickly and efficiently.

Options MMs have to hedge in the underlying stock in order to continue providing liquidity in the options. Unlike a stock market maker, an Options MM does not get “long” the stock when his or her long-sided quotes are accessed. Thus, while selling puts and buying calls in facilitation of incoming orders may be required because of affirmative market making obligations, these facilitation trades do not provide the Options MM with long stock to sell closing and reduce downside risk. The Options MM may, in fact, be long in delta terms but selling stock “short” in stock terms. The liquidity level that Options MMs provide to investors will be diminished by removing the exemption already in place for NASDAQ issues. The current exemption should be preserved and, for the reasons stated above, expanded to include listed stocks as well.

The SEC and the exchanges have acknowledged the important contributions by Options MMs. For example, Options MMs receive exempt-credit for margin purposes under Regulation T to finance their activities as a market maker or specialist. Also, they are provided with an exemption to the “locate” requirement that requires broker-dealers to locate where stock can be borrowed before effecting a short sale in such stock. In Regulation SHO, the SEC states that the locate exception for options market makers is necessary because they may need to facilitate customer orders in a fast moving market without possible delays associated with complying with the proposed ‘locate’ rule. The logic that Options MMs would be disadvantaged if called upon to provide liquidity in an option but not be allowed to hedge against that activity due to the locate rule applies equally to the Short Sale Rule. Whether the Options MMs is precluded from availing upon an appropriate hedging opportunity by way of a locate preclusion or short sale preclusion, the detrimental effect is the same – the Options MM will withdraw long-sided liquidity from the options market. The added dilemma, of course, is that Options MMs are not free to simply or fully withdraw liquidity due their affirmative and negative market making obligations. Thus, the requirement to make a market in a product that cannot be appropriately hedged because of the bid test is a cost that is absorbed by OMMs and then passed on to investors in the marketplace in the form of less liquid and wider quotes.

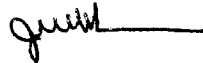
Currently, OMMs have a market maker exemption to the NASD’s Short Bid Rule (Rule 3350) that each day proves itself a valuable asset to the marketplace. While there have been no noted instances of abuse by OMMs trading in NASDAQ stocks pursuant to the exemption, there is the obvious positive aspects of enhanced market maker capabilities in NASDAQ sto

available by the exemption. In any case where the need for additional liquidity has existed in an option-qualified NASDAQ stock in recent years, some or all of that need has been met directly by way of this exemption. The liquidity benefits enjoyed by investors in these stocks should be safeguarded for the future and extended to include listed stocks as well.

## CONCLUSION

The STA supports the Commission's efforts to establish a pilot program to determine the necessity of a short sale rule and its demonstrated effort to address instances of "regulatory arbitrage" and promote uniformity of rules across marketplaces. As discussed above, however, the STA believes that the pilot program period should be reduced and that the securities subject to the program be expanded to provide more complete information concerning the necessity of a bid test rule. While the pilot program is in effect, the STA also supports the establishment of a uniform bid test, however, we believe that due to significant reprogramming and implementation costs and effort necessary to ensure compliance with the rule when firms already have systems in place to comply with the existing NASDAQ short sale rule, a rule that has not been proven to be ineffective, the uniform bid test rule should operate the same as the NASDAQ rule with the exception that the benchmark for compliance would be the consolidated best bid, not the NASDAQ best bid. In order to ensure liquidity in the marketplace and best execution of customer orders we also strongly urge the Commission to provide a bona fide market making exemption to the uniform bid test rule. As described above, we believe the failure to do so would have significant deleterious effects on the marketplace and the execution of customer orders. If we can provide further clarification or further information on this proposal, please do not hesitate to contact me at (212) 867-7002.

Very truly yours,



John C. Giese  
President and Chief Executive Officer